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No. 93-1416

IN THE
Supreme Court of the United States
OCTOBER TERM, 1993

NCR CORPORATION,
Petitioner,
v.
SOUTH CAROLINA
DEPARTMENT OF REVENUE AND TAXATION,
Respondent.

On Petition for a Writ of Certiorari to the Supreme Court of South Carolina

PETITIONER'S REPLY BRIEF

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PETITIONER'S REPLY BRIEF

Respondent's brief in opposition seeks to avoid this Court's review of the decision below by arguing that whether South Carolina's use of its three-factor formula " 'always overtaxes' is not the relevant question . . . ." Opp. at 29. To the contrary, in the context of this Court's Foreign Commerce Clause jurisprudence, the question whether the state's formula always or inevitably results in multiple taxation is not only relevant but decisive, and its presence here calls for this Court's consideration. Due process concerns also require that a formula not systematically overtax but reasonably reflect how income is generated. Simply put, because South Carolina includes previously taxed royalties and interest received by NCR from its unitary foreign subsidiaries in NCR's apportionable income without taking into account the "proportionate measure . . . of the foreign subsidiaries' property, payroll, and sales which generated the NCR income" (Pet. App. D at 40a [1]), South Carolina's formula inevitably overattributes income to South Carolina and creates inevitable international multiple taxation in violation of the Due Process and Foreign Commerce Clauses. By using apportionment factors that are incommensurate with the tax base, the formula is inherently defective and incapable of satisfying the constitutional prescription that it fairly apportion NCR's income to South Carolina.

Instead of confronting this critical defect in South Carolina's formula, respondent contends that no inevitable multiple taxation occurs because (1) the Court's decision in *Container* prevents such a conclusion (Opp. at 5-11), (2) South Carolina is not taxing the royalties and inter-

[1] As described in the petition, this case was remanded in *NCR I* for a refactoring of the formula to take into account this "proportionate measure" of the foreign subsidiaries' factors. As found by the trial court on remand, failure to include the subsidiaries' out-of-state factors that helped generate NCR's apportionable income caused NCR's South Carolina income to be increased by an average of $61,000 or 28% during the years at issue. Pet. App. C at 21a.

est merely by including them in the apportionable tax base (*id.* at 8, 16-18), and (3) South Carolina is merely taxing unitary income whose source cannot be identified. *Id.* at 13-19. Respondent further contends that NCR has no right to factor representation, even if the formula is " 'analytically indefensible' " (*id.* at 20) and " 'always overtaxes' " (*id.* at 29), because, in respondent's view, NCR is entitled to relief only if it can demonstrate a "gross disparity" (*id.*) in the resulting tax.

As we demonstrate below, each of these contentions is wrong for the same reason, namely, respondent's failure to recognize that the principles it espouses, and the authorities it cites, are all predicated on the existence of income tax regimes under which the factors that generate the income being apportioned are included in the apportionment formula. In advancing its arguments, respondent ignores the fact that South Carolina's taxing regime provides for no such factor representation. With this predicate removed, respondent's arguments collapse.

I. *CONTAINER* DOES NOT CONTROL THE ISSUE OF INEVITABLE MULTIPLE TAXATION AS PRESENTED IN THIS CASE

Respondent is simply wrong in suggesting that *Container* "is controlling here since just as in *Container* . . . South Carolina and the foreign countries are merely dividing the same pie (the income of NCR) by different methods." Opp. at 5. Since California required unitary corporations to file a worldwide combined report, the "pie" which was subject to division by California and foreign jurisdictions in *Container* was the combined unitary operating income of Container and all of its domestic and foreign subsidiaries. California divided the pie by formulary apportionment, while foreign jurisdictions divided the pie using an arm's-length separate accounting approach. Although the juxtaposition of those two methods resulted in actual international multiple taxation, this Court correctly determined that this result was not

inevitable. Because the combined reporting method used by California took into account all of the factors of the foreign subsidiaries that contributed to the apportionable combined "pie," it was not inevitable that the foreign subsidiaries' operating income would be attributed to California.

Unlike California, however, South Carolina does not utilize worldwide combined reporting; therefore, in contrast to *Container*, the "pie" in this case cannot be the combined unitary operating income of NCR and its subsidiaries. Rather, the "pie" consists of the interest and royalty income received by NCR from its foreign subsidiaries. While South Carolina taxes only an apportioned share of NCR's royalties and interest, foreign jurisdictions subject the entire amount of this income to tax. In other words, South Carolina taxes a piece of the "pie" but the foreign jurisdictions tax the whole thing. Thus, in contrast to *Container*, juxtaposition of these two methods here inevitably results in international multiple taxation.[2]

II. BY INCLUDING NCR'S INCOME FROM FOREIGN SUBSIDIARIES IN THE APPORTIONABLE TAX BASE WITHOUT INCLUDING THE FOREIGN SUBSIDIARIES' FACTORS IN THE APPORTIONMENT FORMULA, SOUTH CAROLINA INEVITABLY TAXES A SHARE OF SUCH FOREIGN SOURCE INCOME

Respondent contends that South Carolina is not taxing the royalty and interest income that NCR receives from its foreign subsidiaries merely because it includes such income in NCR's apportionable tax base. Opp. at 8,

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[2] One could also define the "pie" to be all the income of NCR, which would include the royalties and interest received from its foreign subsidiaries, but would exclude the operating income of those subsidiaries. This "pie" is also significantly different from that in *Container* because it includes only the separate income of NCR, not of NCR's combined worldwide unitary group of corporations. More importantly, however, an analysis based on this "pie," although slightly more complicated, still leads to the same conclusion regarding inevitable multiple taxation.

16-17. Invoking this Court's decision in *Shell Oil Co. v. Iowa Department of Revenue*, 488 U.S. 19 (1988), respondent misconceives NCR's argument as " 'hing[ing] on the mistaken premise that including . . . income in the preapportionment tax base is tantamount to the direct taxation' " of such income. *Id.* at 30 (quoted in Opp. at 16). Rather, " '[o]nly the fraction of total income that the apportionment formula determines . . . to be attributable to [the state's] taxing jurisdiction is taxed by [the state].' " *Id.* (quoted in Opp. at 16).

NCR agrees that including income in the preapportionment tax base is not the same thing as taxing such income. But that principle has no bearing here because it applies *only* if all of the factors that generate the apportionable income are included in the apportionment formula. Thus in *Shell*, the Court's conclusion that the state was not taxing income from Shell's operations on the Outer Continental Shelf merely because such income was included in Shell's apportionable tax base was reached only because the out-of-state factor [3] that generated the apportionable income was likewise included in the formula employed to apportion Shell's income to the state. *Shell*, 488 U.S. at 22 n.3, 23 n.4.

Similarly, in *Container*, on which respondent places such heavy reliance, the Court concluded that, merely because California required Container to include income earned by its foreign subsidiaries in the apportionable tax base, California was not thereby taxing the same income on which Container's foreign subsidiaries had paid tax abroad. While inclusion of the foreign subsidiaries' income caused Container's apportionable tax base to increase, inclusion of the subsidiaries' factors caused its apportionment percentage to decrease. Depending on the relative impact of these two changes, the income apportioned to California could have increased, decreased, or remained the same. *See* Pet. at 15 n.11.

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[3] Unlike most states which employ a three-factor formula of property, payroll, and sales for apportioning net income, Iowa employs a single-factor sales formula to apportion income to the state.

In striking contrast to the apportionment schemes at issue in both *Shell* and *Container*, South Carolina's taxing scheme insures that inclusion in the apportionable tax base of the income under consideration will lead to the taxation of such income. Unlike Iowa in *Shell* and California in *Container*, South Carolina did not include all of the factors that generated the income in question in the apportionment formula. Consequently, while NCR's apportionable tax base was increased by the inclusion of the royalties and interest, there was no change in its South Carolina apportionment percentage to account for the factors of NCR's subsidiaries that generated such royalties and interest. Pet. App. D at 29a. When there is an increase in apportionable income, and the apportionment percentage remains the same, it is a matter of mathematical certainty that an apportioned share of the additional income will be taxed.

III. THE SOURCE OF NCR'S INCOME HAS NO BEARING ON ITS CLAIM OF INEVITABLE MULTIPLE TAXATION

Much of respondent's brief in opposition is devoted to establishing that NCR is unable to identify the source of the royalty and interest income that it receives from its foreign subsidiaries. Respondent contends that the royalties and interest have no identifiable source because they are part of NCR's unitary income. From this premise, respondent argues that South Carolina is not taxing the same foreign source royalties and interest on which NCR pays taxes to foreign countries because "classification of the income as unitary income eliminates any consideration of the foreign source of the income." Opp. at 15. Accordingly, in respondent's view, NCR's claim of inevitable multiple international taxation must fail.

In fact, the source of NCR's royalties and interest is irrelevant to NCR's claim of inevitable multiple taxation. Inevitable multiple taxation of NCR's royalties and interest occurs due to the simple fact that the same royalties and interest—*regardless of their source*—are taxed

both by foreign countries and by South Carolina. Pet. App. D at 27a, 29a. Because South Carolina included the royalty and interest income in the apportionable tax base without adjusting NCR's apportionment formula to reflect the factors that generated such income, it inevitably taxed an apportioned share of the royalty and interest income. *See supra* pp. 3-5. Consequently, it is undeniable that, whatever the source of NCR's royalties and interest, South Carolina's taxing scheme inevitably results in the taxation of the same royalties and interest that are subjected to tax abroad.[4] In any event, it is plain that unitary income does have a source. It is earned in *all* of the jurisdictions in which the unitary business operates, and it can be traced to *all* of the business's property, payroll, and sales.

IV. RESPONDENT HAS OFFERED NO PRINCIPLED RESPONSE TO NCR'S CLAIM THAT THE FACTORS THAT GENERATED ITS ROYALTY AND INTEREST INCOME MUST BE REPRESENTED IN NCR'S APPORTIONMENT FORMULA

NCR contended in its petition that this case raises a question of great practical importance, which this Court left open in *Mobil* and which has subsequently divided state courts of last resort, namely, whether a state may include in a corporation's apportionable tax base income received from its unitary foreign subsidiaries without taking account of the subsidiaries' income-producing factors in the apportionment formula. NCR also pointed out that the failure to provide for factor representation in

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[4] Indeed, the New Mexico Taxation and Revenue Department, which has opposed NCR's pending petition for certiorari in a case that is virtually identical to this one, explicitly concedes that "[e]ach foreign nation's allocation to itself of all of NCR's income earned in that nation will always and necessarily overlap with every state's apportioned tax system." Opp. at 10, *NCR Corporation v. Taxation and Revenue Department of the State of New Mexico*, No. 93-541. Despite the differences between New Mexico and NCR on other issues, both parties agree on the critical fact that the state is seeking to tax the very same royalties and interest that have been taxed abroad.

such circumstances would inevitably attribute too much income to the taxing state.

Respondent makes no effort to defend South Carolina's apportionment scheme on the merits. Instead, respondent claims it is irrelevant whether South Carolina's "formula is 'theoretically sound' or 'analytically defensible' " (Opp. at 20) or whether it " 'always overtaxes.' " *Id.* at 29. The only "relevant question" (*id.*), according to respondent, is whether the formula creates a "gross disparity." *Id.* In fact, the truly relevant question—and the one that demands this Court's attention—is whether the "relevant question" that respondent would answer is all that the Constitution requires.

Although NCR believes that respondent is profoundly misguided in its view of the law, *see* Pet. at 22-23, respondent's position in any event demonstrates the need for the Court's review of this case. Only this Court can resolve the question whether the good-enough-for-government-work defense espoused by respondent is a constitutionally sufficient answer to the systematic overtaxation to which South Carolina's taxing regime subjects NCR. Only this Court can determine whether the powerful case for factor representation advanced by Justice Stevens in his dissent on the question the Court left open in *Mobil* may be ignored by state courts. And only this Court can resolve the conflict between those state courts that have embraced Justice Stevens' views and those, like the court below, which have rejected it.

Several points that respondent offers in defense of South Carolina's taxing scheme nevertheless warrant brief attention. First, respondent claims that South Carolina "has allowed factor consideration for the royalty and interest by an adjustment that increases the sales denominator by including the royalties and interest." Opp. at 28. This defense fails because merely including the intangible income that NCR receives from its unitary foreign subsidiaries in NCR's sales factor—rather than including the factors of the subsidiaries themselves—does not reflect how income is generated. As the Court ob-

served in *Container*, "the factor or factors used in the apportionment formula must actually reflect a reasonable sense of how income is generated." *Container*, 463 U.S. at 169. The minuscule adjustment that South Carolina actually made in NCR's apportionment percentage (*e.g.*, 0.4% for 1981) does not begin to reflect the contribution that the subsidiaries made to NCR's apportionable income (*e.g.*, 67% for 1981). Pet. at 22 n.14.

Second, respondent seeks to distinguish this case from *Mobil* on the ground that this case involves royalties and interest rather than dividends. "[W]here the income paid out, such as royalty and interest, is a mere expense of the subsidiaries in performing their business in the foreign location, there are no 'earnings' of the subsidiary that need to be accounted for in the factors of the recipient." Opp. at 23. Respondent's argument loses sight of the rationale on which it is taxing NCR's royalties and interest. The only reason that the royalties and interest are includible in NCR's South Carolina tax base is because they arise out of NCR's unitary business conducted with its foreign subsidiaries. Whether the unitary income derived from NCR's foreign subsidiaries takes the form of dividends, interest, or royalties is constitutionally irrelevant. As the Court declared in *Mobil*, and, indeed, as respondent recognizes (Opp. at 8), it is the "underlying activity" not the "form of investment" that informs the constitutional rules in this domain. *Mobil*, 445 U.S. at 440. As long as the royalty and interest income derives from NCR's unitary business, as it admittedly does in this case, then the income is apportionable and the underlying factors that generate such income must be reflected in the apportionment formula.[6]

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[6] Respondent suggests that NCR's position is "tantamount to holding that a state may not tax income that is 'foreign' (i.e. taxed by a foreign jurisdiction) unless the state taxes the income on the combined unitary method . . . ." Opp. at 14. The suggestion is baseless. All NCR seeks is that the factors that generated such income be included in the apportionable tax base. This is a far cry from combined reporting, whereby South Carolina would include in the apportionable tax base the operating income of the foreign

Third, respondent's efforts to distinguish the cases that squarely conflict with the decision below lack substance. Respondent blatantly misstates the Maine Supreme Court's holding in *Tambrands* in suggesting (1) that the case turned entirely on the application of the "internal consistency" test and (2) that, because the distortion resulting from the lack of factor representation amounted to only 14.9%, the *Tambrands* court "concluded that the external consistency test was not violated." Opp. at 26. In fact the court declared that "[e]ven assuming that the Assessor's formula is constitutionally valid under the internal consistency test, it results in taxation of value extraterritorial to Maine and is contrary to due process . . . ." *Tambrands*, 595 A.2d at 1044; *see also* Pet. at 19-20.[6]

Respondent likewise misreads *American Tel. & Tel.*, in asserting that it was decided under the "gross disparity test" (Opp. at 25) rather than on the ground that the formula was inherently defective. In fact, the Wisconsin court in *American Tel. & Tel.* required a modification of the apportionment formula because "the apportionment formula used by the department does not reflect a reasonable sense of how A.T.&T.'s income is generated" (*AT&T*, 143 Wis. 2d at 551, 422 N.W.2d at 636), not because the application of the formula to the taxpayer produced a grossly distorted result. *See* Pet. at 20-21. As for *Homart*, respondent seeks to distinguish the case on the ground that it involves a partnership rather than a corporation. Opp. at 27-28. But it fails to explain why the principle underlying the case—that "inclusion of this income in Homart's net-income calculation . . . *necessarily* requires that the payroll, property, and receipt factors that gave rise to it be included in the apportionment equation also" *Homart*, 529 A.2d at 121 (emphasis supplied)—is

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subsidiaries, and the royalties and interest at issue would be eliminated as intercompany items.

[6] Even the New Mexico Taxation and Revenue Department, which has opposed NCR's petition for certiorari in *NCR Corp. v. Taxation and Revenue Department, supra* (No. 93-541), concedes that *Tambrands* is in conflict with decisions denying a right to factor representation. Opp. at 15, *id.*

any less applicable to corporate entities than to partnerships.

Finally, respondent cannot resist yet another citation to *Container*, this time for the proposition that "[t]he three-factor formula has been conclusively found to be fair," Opp. at 28-29, and that it is therefore appropriate to measure the constitutionality of South Carolina's inexorable overtaxation only by the relaxed " 'gross disparity' test." *Id.* at 28. Respondent's argument once again stumbles over its own premises. To be sure, the standard three-factor formula employed by California in *Container* is similar to that used by South Carolina here. But respondent fails to recognize, as it has throughout its brief in opposition, that the three-factor formula the Court endorsed in *Container* as "fair" (*Container*, 463 U.S. at 169-70) was fair only because the formula included all of the factors of the subsidiaries whose income was being apportioned. Here, by contrast, the three-factor formula reflects only the activities of NCR itself and wholly fails to reflect any of the factors of the subsidiaries that generated NCR's royalty and interest income.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted,

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